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SUBJECT: CHANCELLOR MERKEL'S NEW COALITION: WHAT IT MEANS
FOR GERMANY'S ECONOMIC AGENDA

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BERLIN 00001243 001.2 OF 005

11. (SBU) SUMMARY: Germany's election of a center-right governing coalition, composed of the Christian Democratic Union (CDU), its Bavarian sister party the Christian Social Union (CSU), and the Free Democratic Party (FDP), was supposed to herald a shift to a more business-friendly government. The reality may be something less than that as campaign rhetoric collides with exploding deficits and other constraints; tax cuts, for instance, will be limited as the government strives to rebalance budgets. On economic and social issues, look instead for a continuation of many of the same policies of the Grand Coalition, with a few concessions to business. The same goes for labor and social welfare programs. Although the CDU/CSU took pains in the election campaign to present themselves as ideological bedfellows with the FDP, Merkel, as head of the coalition government staked out economic positions that frequently mirrored those of her SPD Finance and Labor Ministers. With Merkel still at the helm, any drift to the right will be tempered by the Chancellor's own commitment to "social market economy" principles. Major cutbacks on aid to job-sensitive industries like autos and on health care spending are therefore unlikely, as are an early privatization of Deutsche Bahn and a shake-up of labor hiring and firing policies. A similar dynamic may play out on the energy and environmental agenda with Merkel, the committed environmentalist, in a tussle with the more pro-growth FDP. The FDP is also unlikely to win a battle with Merkel to loosen constraints on German business with Iran. Ultimately, the makeup of Merkel's cabinet (see also septel) may be as consequential for the Black-Yellow coalition's economic policies as the negotiated coalition agreement. END SUMMARY.

THE ECONOMIC AGENDA: CONTINUITY AND MODEST CHANGE

12. (SBU) As the new coalition prepares itself to take power, initial economic challenges will be largely tactical. (NOTE: Chancellor Merkel (CDU), Minister-President Horst Seehofer (CSU) and presumed Vice Chancellor and Foreign Minister Guido Westerwelle (FDP) are aiming to sign a coalition agreement by November 9 at the latest, before the anniversary events for the fall of

the wall.) The Chancellor, accustomed to moderating demands from her SPD partner to the left, will now find herself at the other end of the political spectrum, as she tries to balance pro-business FDP objectives with what some refer to as her "social democratic course." Early statements indicate that she intends to block FDP assaults on some policy positions taken by the previous Grand Coalition. Potential flashpoints include financial market regulation, targeted state intervention on behalf of troubled industries and companies, and health care policy. CDU sources tell us consideration of these issue areas may also guide the party as it parcels out the various ministries. "In financial matters, working with the FDP will become more difficult, certainly in the beginning," a Chancellery contact told us. The party will have a "steep learning curve and will have to modify and moderate its positions on several policy areas."

13. (SBU) A key issue to watch will be tax reform (reftel); the CDU and FDP will have to deliver, after making this their central economic campaign issue. The CDU envisaged decreasing the corporate tax rate, and using tax incentives to encourage public and private sector research and development. The FDP promised a radical overhaul of the entire system, with lower rates at some levels but higher rates at others; the net effect, however, would be a 35 billion euro loss in revenues, according to independent estimates. Tax policy could, therefore, be a point of contention, but lower rates for small earners and for families, as well as some cuts in the corporate tax, are likely outcomes in any event.

14. (SBU) With an expected budget deficit of more than 2 percent this year and 4 percent in 2010 -- just as mid-

BERLIN 00001243 002.2 OF 005

term targets for Germany's balanced budget amendment kick in, mandating structural deficits of no more than 0.35 percent -- the new coalition will face strong pressures on revenues. A VAT hike, at least in the near term, is unlikely since Merkel publicly ruled it out. Tax cuts, however, could be accompanied by a "streamlining" of the tax code: code for phasing out subsidies. Cutbacks in pensions, health care, unemployment support will be more difficult, since less funding for these social systems would increase costs for companies, which the FDP would staunchly oppose. A senior Chancellery official envisages a net fiscal impact of around 10 billion euros at the most. Bottom line: the scope for cuts is limited.

THE LABOR/SOCIAL AGENDA: MERKEL'S BACKYARD

15. (SBU) In their initial reactions to the election result, ranking union leaders warned the new coalition government against embarking on a "neo-liberal policy course" and to respect worker rights. The main reason for their concern is the FDP's election platform which, inter alia, calls for limiting labor's role in company advisory boards and work councils, and for measures to weaken protection against dismissal rules and collective bargaining coverage.

16. (SBU) Disappointed with the election outcome, German Trade Federation (DGB) President Michael Sommer warned against "an eradication" of the social-welfare system due to the crisis. In a televised interview the day after the election, Sommer reminded Chancellor Merkel to keep her promise not to weaken the existing protection against dismissal regulations. Sommer characterized FDP demands as a "declaration of war" against the unions, and warned the new coalition of "consequences." If necessary, unions would be able to mobilize resistance, Sommer held.

17. (SBU) Despite the sharp public rhetoric, union

leadership knows it needs to continue on its current moderate course, including restraint on wage increases. In order to influence policymakers, leaders have scheduled a meeting with Merkel to discuss the economic crisis and the new coalition agreement. Union leaders know that Merkel is their potential ally in the coalition and will not hesitate to woo her. In a similar vein, Hubertus Schmoldt, outgoing chair of the Mine, Chemical and Energy Workers Union (IG BCE) noted, "The election result is obviously not what we had wanted, but we will look for a dialogue and cooperation."

18. (SBU) In a September 29 meeting, IG Metall's North Rhine-Westphalia district leader Oliver Burkhard told Embassy that the election outcome could be attributed, in part, to the SPD's obvious lack of "compassion" for the "ordinary people" most seriously affected by former Chancellor Schroeder's Agenda 2010. Burkhard was cautiously optimistic that a CDU-led government might correct some shortcomings in the labor market and pension reforms, and did not expect major changes in labor law or worker participation rights. "The FDP will not prevail," he said, referring to statements by prominent CDU leaders in North Rhine Westphalia such as Pofalla (a possible new Labor Minister), NRW Labor Minister Laumann (chair of the CDU's labor wing, and also a potential candidate for Labor Minister) and NRW M-P Juergen Ruetters, who immediately after the elections strongly warned the FDP not to expect the new government to touch hot button issues like protection against dismissals, co-determination or health insurance system. The coalition leader, Merkel, is likely to agree.

STATE BAILOUTS: THE OPEL TEST CASE

19. (SBU) Opel and Hypo Real Estate (HRE) may be early test cases for the new coalition. Voices in the FDP (and CDU/CSU) bemoaned the Grand Coalition's willingness to prop up struggling firms through take-over, loan guarantees and other market interventions. Serious debate, however, centered mainly on which firms were

BERLIN 00001243 003.2 OF 005

systemically important enough to be saved, and how many jobs were at stake.

110. (SBU) During the campaign, FDP-leader Guido Westerwelle criticized Merkel's handling of the Opel bailout, but steered clear of dismissing a government role in saving Opel jobs, some of which are found in his home state of North Rhine-Westphalia. The Chancellor could use a calculated confrontation with the FDP to demonstrate CDU compassion. Where such a strategy would leave the CSU and, in particular, the current Economics Minister zu Guttenberg, is an open question, since zu Guttenberg once advocated insolvency for Opel. On the other hand, the Chancellor is also vulnerable. As the Magna deal becomes more complicated and mired in controversy, it could well become more draining on taxpayers. Not facing these constraints, the FDP could argue against shoveling more public funds into Opel.

PRIVATIZATION: NOT SO EASY

111. (SBU) The previous government was committed to the privatization of the public sector German Railway (Deutsche Bahn - DB). Evidence of mismanagement, however, forced repeated delays of the plan to place DB stock up for sale. Analysts have concluded that the troubled company is no longer a viable candidate for privatization. In addition, the protracted recession has hurt railways badly, making it difficult to find

investors willing to purchase DB stock. Ever the pragmatist, Chancellor Merkel would likely be willing to delay privatization indefinitely. The FDP, by contrast, is committed to privatization of public sector holdings on ideological grounds and could press for the plan to proceed, even if this is not the right time.

NUCLEAR PHASE-OUT ON HOLD?

¶12. (SBU) During the campaign, the SPD tried to make nuclear power into an issue, but it failed to resonate with the voters. The SPD argued that under no circumstances would it delay the phase-out of Germany's nuclear power plants. (NOTE: The current arrangement would close the last reactor some time around 2020.) The FDP favored extending the life of the reactors. Merkel refused to be pinned down, stating only that nuclear power must serve as "bridging energy" until renewable energy sources are fully up and running.

¶13. (SBU) With the SDP now in opposition, the CDU-FDP coalition is likely to become more sympathetic toward nuclear power. The CEOs of energy giants RWE and E.ON have offered to turn over to the government part of the additional earnings generated by any extension of nuclear power. As the EU's cap and trade system becomes more widespread, nuclear power could become more attractive. Should Germany proceed with the phase-out, it has few viable options to replace the power generated by nuclear reactors, which currently provide 23 percent of the country's power needs. The introduction of more coal-fired plants with their large CO2 emissions would be prohibitively expensive while greater use of natural gas would increase Germany's dependence on Russia, the only viable supplier. A CDU-FDP coalition could opt for an extension, although it would touch off a serious battle with the opposition and a hot public debate; Germans from across the political spectrum oppose nuclear power.

HOW GREEN ARE YOU REALLY?

¶14. (SBU) Under the Grand Coalition, Germany embraced environmentalism with an enthusiasm rarely seen in other countries. Large tax-payer subsidies have fueled the creation of an enormous renewable power industry and Germany has surpassed its Kyoto Accord goals for curbing CO2 emissions. This has come at a heavy price and become

BERLIN 00001243 004.2 OF 005

the cause of considerable complaint from many of those who voted for the incoming CDU-FDP coalition. More conservative voters argue that Germany should not take an economic hit to meet its climate change and environmental goals, while economic rivals like China and India ignore global warming and the environment to procure an advantage.

¶15. (SBU) Originally hailed in the media as the "Climate Chancellor" for her efforts to elevate awareness of environmental concerns, Merkel, along with the SPD, implemented large, taxpayer-subsidized plans that helped build a world-renowned renewable energy industry. Merkel remains under pressure from German heavy industry concerned about carbon leakage and resulting job losses, however, especially in the auto, steel, chemical, aluminum, and cement industries. Last December, Chancellor Merkel and the Economics Ministry lobbied the EU Commission to exempt German heavy industry from the planned auction of carbon permits in the EU Emissions Trading Scheme (ETS). She also expressed deep opposition to EU legislation seeking to tax emissions from large cars, which would hurt the luxury sedans produced by

German automakers. Against the backdrop of a shaky economy, we expect to see the new coalition seek to navigate between the Scylla of climate advocates and the Charybdis of heavy industry. Merkel will likely seek to execute her domestic climate renewable and energy efficiency plan, but with little further ambition, particularly if she is tugged back by the FDP.

COMPLICATING SANCTIONS AND EXPORT CONTROLS

¶16. (SBU) The shift in coalition partners from the SPD to the pro-business/pro-export FDP may also complicate Merkel's desire to tighten sanctions against Iran should diplomacy fail. A FDP-led MFA is likely to keep the interest of their core business constituency in mind, particularly in times of financial crisis, and may be reluctant to back stronger sanctions that would negatively impact German exports. In addition, the new coalition may become more liberal on the exports of "war weapons," particularly in politically sensitive cases that are decided by the "Bundessicherheitsrat" (national security council) - a panel composed of Merkel and the Ministers of Foreign Affairs, Defense, Finance, Economics, Interior, and Justice, which will be populated exclusively by CDU/CSU and FDP party members. On the other hand, the export control authority for civil and dual-use goods, BAFA, is an independent agency within the Ministry of Economics and in theory is independent from any shift in the governing coalition. And if Merkel decides on tougher sanctions for security considerations, that will trump the concerns of German business in Iran.

MINISTERIAL ROULETTE

¶17. (SBU) While speculation over future Black-Yellow policies is becoming a national pastime, the direction of the new coalition's economic, social and environmental policies is largely a question of who will lead the various ministries (see septel for full cabinet discussion). The Finance Ministry is seen as the big prize, with the Economics Ministry trailing somewhat behind. Although the Labor Ministry does not have the same cache, it is an important bellwether of social issues. Options follow:

--Finance: CDU will like to control the purse strings, but lacks financial expertise. Hesse Bundestag Member Roland Koch is mentioned as a possibility, but he has shown no signs of interest. Current Economics Minister zu Guttenberg is another, as is Hans-Otto Solms (FDP). Bottom line: No clear front runner.

--Economics: Although the FDP may want it, it has only one viable candidate: Rainer Bruederle. Succeeding the youthful and dynamic zu Guttenberg will be a hard act to follow for the soft-spoken, 60 year-old Bruederle.

BERLIN 00001243 005.2 OF 005

Moreover, zu Guttenberg is rumored to want to stay on as Economics Minister.

--Labor: The CDU wants it to emphasize its credentials on social policies. The Chancellor may want to reward loyal stalwarts such as CDU Secretary General Ronald Pofalla. Josef Laumann, Social Affairs Minister in North Rhine-Westphalia is another leading contender (see septel).

MURPHY